Gregg M. Galardi, Esq.
Ian S. Fredericks, Esq.
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
One Rodney Square
P.O. Box 636
Wilmington, Delaware
19899-0636
(302) 651-3000

- and -

Chris L. Dickerson, Esq.
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
155 North Wacker Drive
Chicago, Illinois 60606
(312) 407-0700

Dion W. Hayes (VSB No. 34304)
Douglas M. Foley (VSB No. 34364)
MCGUIREWOODS LLP
One James Center
901 E. Cary Street
Richmond, Virginia 23219
(804) 775-1000

Counsel to the Debtors and
Debtors in Possession

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
RICHMOND DIVISION

In re:	:	Chapter 11
CIRCUIT CITY STORES, INC., et al.,	:	Case No. 08-35653 (KRH)
Debtors.	:	Jointly Administered

DEBTORS' OMNIBUS REPLY IN SUPPORT OF FORTY-EIGHTH AND FIFTIETH OMNIBUS OBJECTIONS TO CERTAIN ADMINISTRATIVE EXPENSES AND 503(b)(9) CLAIMS AND MOTION FOR (I) AUTHORITY TO SETOFF AGAINST SUCH EXPENSES AND CLAIMS AND (II) A WAIVER OF THE REQUIREMENT THAT THE FIRST HEARING ON ANY RESPONSE PROCEED AS A STATUS CONFERENCE

Circuit City Stores, Inc. ("Circuit City") and

its subsidiary debtors and debtors in possession in the above-captioned cases (collectively with Circuit City, the "Debtors"),[1] hereby submit this Omnibus Reply (the "Reply") in support of the Debtors' Forty-Eighth and Fiftieth Omnibus Objections to Certain Administrative Expenses and 503(b)(9) Claims and Motion for (I) Authority to Setoff Against Such Expenses and Claims and (II) a waiver of the Requirement that the First Hearing on any Response Proceed as a Status Conference (D.I. 5211 & 5213); together, the "Objection")[2] and hereby respectfully state as follows:

[1] The Debtors and the last four digits of their respective taxpayer identification numbers are as follows: Circuit City Stores, Inc. (3875), Circuit City Stores West Coast, Inc. (0785), InterTAN, Inc. (0875), Ventoux International, Inc. (1838), Circuit City Purchasing Company, LLC (5170), CC Aviation, LLC (0841), CC Distribution Company of Virginia, Inc. (2821), Circuit City Properties, LLC (3353), Kinzer Technology, LLC (2157), Abbott Advertising Agency, Inc. (4659), Patapsco Designs, Inc.(6796), Sky Venture Corp. (0311), PRAHS, INC.(n/a), XSStuff, LLC (9263), Mayland MN, LLC (6116), Courchevel, LLC (n/a), Orbyx Electronics, LLC (3360), and Circuit City Stores PR, LLC (5512). The address for Circuit City Stores West Coast, Inc. is 9250 Sheridan Boulevard, Westminster, Colorado 80031. For all other Debtors, the address was 9950 Mayland Drive, Richmond, Virginia 23233 and currently is 4951 Lake Brook Drive, Glen Allen, VA 23060.

[2] Each capitalized term not otherwise defined herein shall have the meaning ascribed to it in the Objection.

PRELIMINARY STATEMENT

1. By the Objections, the Debtors object to certain 503(b) Administrative Expenses and 503(b)(9) Claims -- the Administrative Expenses -- on the basis that such Administrative Expenses should be reduced on account of Circuit City's setoff rights. In an effort to ease the administrative burden on this Court and provide affected creditors with the opportunity to participate in the resolution of common legal issues, the Debtors also request that this Court bifurcate the hearing on the Objection.

2. Specifically, the Debtors request that this Court resolve any common legal issues at the initial hearing on November 12 (the "Hearing") and reserve any factual issues for subsequent hearings with respect to each Claimant that responded (each a "Respondent" and, collectively, the "Respondents"). Only after each such subsequent hearing would the Court enter an order sustaining/overruling the Objections. In the Debtors' view, this process protects creditors' rights.

3. Nearly every Respondent objected, raising, among other things, due process and other constitutional objections and arguing that the Debtors were required to commence an adversary proceeding to obtain the relief

sought by the Objections. As discussed herein, the proposed process of bifurcating legal and factual issues (i) satisfies constitutional due process, (ii) presents justiciable issues properly considered by the Court and does not constitute a request for an advisory opinion, and (iii) is a cost effective mechanism accepted by other bankruptcy courts facing similar issues. Moreover, because the Debtors are not requesting any affirmative relief, i.e., the recovery of money or property or a declaration, but simply a ruling on threshold legal issues in a form similar to seeking partial summary judgment, they were not required to commence an adversary proceeding. Consequently, the Respondents' procedural objections should be overruled and this Court may proceed to decide the threshold legal issues presented by the Objections, the Responses, and this Reply.[3]

[3] By this Reply, the Debtors have attempted to address all issues that are ripe for consideration at the Hearing. To the extent the Debtors have not specifically addressed an argument in this Reply, the Debtors reserve the right to address such argument at the Hearing or in supplemental submissions. Nothing herein shall constitute a waiver of such rights. All rights are expressly reserved.

THRESHOLD LEGAL ISSUES[4]

4. To assist the Court and the Respondents, the Debtors have identified the following four threshold legal issues, which include the procedural issues raised by the Respondents, should be resolved at the Hearing:

I. Issue: Whether this Court may bifurcate the hearing and resolve common legal issues prior to making findings of fact with respect to the specific claims of a Respondent?

Respondents' Position: Bifurcating the hearing violates the Respondents' due process rights and any decision by the Court violates Article 2 of the Constitution because the Debtors are requesting an advisory opinion.

Debtors' Position: The process proposed by the Debtors (i) protects the Respondents' due process rights because their right to a subsequent, individual judicial determination is preserved, (ii) is not a request for an advisory opinion because there is a justiciable case and controversy, and, thus, in essence a request for partial summary judgment proper in the context of a contested matter under Bankruptcy Rule 9014, and (iii) has been used by other bankruptcy courts to address similar disputes. Accordingly, the Court may properly bifurcate the hearing on the Objections and address common legal issues prior to resolving factual disputes.

[4] This section is intended as a summary of the legal issues presented by the Objection, the Responses, and this Reply, as well as the general position of the various Respondents and the Debtors' position. The "Respondents' Position" may vary somewhat from Respondent to Respondent and not all Respondents presented all of the arguments addressed herein.

II. Issue: Whether the Debtors were required to commence an adversary proceeding?

Respondents' Position: The Debtors are seeking a declaratory judgment or to recover money or property, which must proceed by adversary proceeding.

Debtors' Position: Setoff is a defense that may be raised in a claim objection and the Debtors need not proceed in an adversary proceeding. In that regard, the Debtors are not seeking to affirmatively recover money or property nor are they seeking a declaration regarding any such recovery. Instead, the Debtors are seeking a ruling on threshold legal issues similar to seeking partial summary judgment in the context of a claims objection under Bankruptcy Rule 3007 and a contested matter governed by Bankruptcy Rule 9014. Thus, it was not necessary for the Debtors to commence an adversary proceeding under Bankruptcy Rule 7001.

III. Issue: Whether the Debtors may setoff the Receivables, arising pre- or post-petition, against the Administrative Expenses, even if the Respondent has an alleged general unsecured pre-petition claim? If the Debtors are not permitted to setoff the Receivables against the 503(b) Administrative Expense when the Respondent holds an alleged general unsecured claim, whether the Debtors may setoff the Receivables, arising pre- or post-petition, against the 503(b)(9) Claims?

Respondents' Position: Although the Debtors are authorized under Bankruptcy Code section 558 to setoff pre-petition receivables against post-petition administrative expenses, such relief is not warranted when a creditor also holds a general unsecured claim.

Debtors' Response: Setoff is an equitable remedy and the equities, as well as Bankruptcy Code goals and objectives, favor authorizing the Debtors to setoff the Receivables against the

Administrative Expenses. Even assuming, arguendo, that the Debtors are prohibited from setting off pre-petition Receivables against 503(b) Administrative Expenses, the 503(b)(9) Claims are pre-petition claims, and, consequently, the Debtors should be authorized to setoff the Receivables against the 503(b)(9) Claims.

IV. Issue: Whether the defense of recoupment precludes the Debtors from setting off the Receivables against the Administrative Expenses? If recoupment applies, whether the logical relationship standard or the integrated transaction standard applies?

Respondents' Position: The Respondents should be able to recoup under either the logical relationship or the integrated transaction standard.

Debtors' Position: As both setoff and recoupment are equitable defenses, the equities favor the Debtors' setoff rights under Bankruptcy Code section 558. If recoupment applies, this Court should adopt the integrated transaction standard and, consistent with courts in this District and across the country, construe it narrowly.

APPLICABLE AUTHORITY

I. THIS COURT MAY BIFURCATE THE HEARING AND RESOLVE COMMON LEGAL ISSUES PRIOR TO MAKING FINDINGS OF FACT WITH RESPECT TO EACH RESPONDENT.

5. In the Objections, the Debtors requested that this Court bifurcate the hearings on the Objections to address threshold legal issues at the first hearing, and leaving factual issues for any subsequent hearings after discovery. Certain Respondents object to this request

arguing that it denies them due process and that any decision rendered at the first hearing would constitute an advisory opinion.[5] The Respondents' arguments should be rejected on four grounds.

6. First, the bifurcated hearing process does not deny the Respondents' due process rights. The Fourth Circuit Court of Appeals has recognized that due process is not a "technical conception of inflexible procedures." A.H. Robins Co. v. Piccinin, 788 F.2d 994, 1014 (4th Cir. 1986) (internal quotation omitted). "[R]ather, [it is] a delicate process of adjustment and of a balancing of interests in which it is recognized that what is unfair in one situation may be fair in another." Id. (internal quotations omitted). Moreover, when a dispute involves property rights only, "mere postponement of the judicial enquiry is not a denial of due process, if the opportunity given for ultimate judicial determination . . ." is preserved. Id. (citing Parratt v. Taylor, 451 U.S. 527, 540 (1981)).

[5] See Response of Alliance Entertainment ("Alliance") (D.I. 5481), at p. 8 ¶15; Response of Averatec/Trigem USA, Inc. ("Averatec") (D.I. 5415), at p. 8; Response of Vonwin Capital Management, L.P. (D.I. 5509), at p. 3, incorporating the Response of Averatec (D.I. 5415).

7. Here, the Debtors are proposing a two step adjudication process whereby, first, the Court addresses threshold legal issues common to all Respondents, and, second, the Court may hold subsequent hearings to address factual issues that may be unique to a Respondent. Thus, no "ultimate judicial determination" is made without a Respondent receiving adequate notice and opportunity to be heard on all issues. Consequently, there is simply no due process violation.

8. Second, this Court is not being asked to render an advisory opinion by resolving the threshold legal issues presented by the Objections and Responses. Specifically, the Court would be issuing an advisory opinion if the Court were being asked to render a decision based on hypothetical facts, or to address abstract issues lacking a concrete factual basis. See In re Nixon, 2007 WL 1394033, *3 (Bankr. N.D. W. Va. May 9, 2007). A party is not seeking an advisory opinion when "the facts alleged, under all the circumstances, show that there is a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality." Id. (quoting Maryland Cas. Co. v. Pacific Coal & Oil Co., 312 U.S. 270, 273 (1941)).

9. Moreover, courts have held that a party is not seeking an advisory opinion merely by requesting that the court address threshold legal issues before making a determination on underlying facts. See Thomas v. Union Carbide Agric. Prods. Co., 473 U.S. 568, 581 (1985) ("The issue presented in this case is purely legal, and will not be clarified by further factual development . . . . 'One does not have to await the consummation of threatened injury to obtain preventive relief. If the injury is certainly impending, that is enough.'") (citation omitted); Pac. Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm'n, 461 U.S. 190, 201 (1983) (holding that a case is ripe for decision even though all the factual predicates ordinarily necessary for review have not been met when the question presented was predominantly legal and withholding a decision would work a substantial hardship on the parties); Satellite Broad. & Communs. Ass'n v. FCC, 275 F.3d 337, 369 (4th Cir. 2001) (holding that a case is ripe for review when it raises purely legal questions).

10. Here, however, the Debtors are requesting that the Court rule on specific threshold legal issues presented by a multitude of Claims and Responses. These legal issues are live controversies or disputes between the

Debtors. Indeed, in the Objections, the Debtors have set forth sufficient facts to demonstrate that there is a substantial controversy between the Debtors and the Respondents and that the parties have adverse legal interests of sufficient immediacy and reality such that there is a justiciable issue to be resolved, not an advisory opinion requested.

11. Third, the process the Debtors are seeking to employ fits easily within the Bankruptcy Rules. As this Court well knows, pursuant to Bankruptcy Rule 3007 a claims objection need not be made in an adversary proceeding. Moreover, upon receiving the Responses, the claims objection is a contested matter governed by Bankruptcy Rule 9014. See In re Fleming, 2008 WL 4736269, * 1 (Bankr. E.D. Va. Oct. 15, 2008) (Huennekens, J.) ("The hearing on the claim objection is treated as a contested matter, and Fed. R. Bankr. P. 9014 applies."). As such, certain rules, under part VII of the Bankruptcy Rules are applicable, including Bankruptcy Rule 7056, which incorporates Rule 56 of the Federal Rules of Civil Procedure (the "Civil Rules"). See id.; see also Fed. R. Bankr. P. 7056.

12. Under Civil Rule 56, a party may request partial summary judgment. See Fed. R. Civ. P. 56(a), (b)

(providing that any party "may move, with or without supporting affidavits, for summary judgment on all or part claim."). Here, the Debtors have, in essence, requested partial summary judgment on certain legal issues for which no genuine issue of material facts is in dispute. Thus, the Debtors' request to bifurcate the hearings is proper under the applicable rules of Bankruptcy Procedure.

13. Finally, the same exact process requested by the Debtors has been followed by other bankruptcy courts in similar situations. See, e.g., In re Leeds Bldg. Prods., Inc., 141 B.R. 265, 266 (Bankr. N.D. Ga. 1992) (implementing a bifurcated hearing process whereby threshold legal issues were resolved prior to making specific findings of fact concerning each claimant); In re Plastech Engineered Prods., Inc., 394 B.R. 147, 149 (Bankr. E.D. Mich. 2008) (issuing an opinion addressing a legal threshold issue without making findings as to the merits of any particular claim).[6] In that regard, the decision in

[6] See also In re Stegall, No. 05-09519, 2007 WL 1125635, *1 (Bankr. S.D. Iowa Apr. 3, 2007) (noting that the court would consider the primary threshold legal issue before receiving factual information or a presentation of evidence on the merits of the parties' claims); In re Hackney, 351 B.R. 179, 181 (Bankr. N.D. Ala. 2006) (holding that the court would consider the threshold legal issue underlying a claim before it considered the claim's merits); In re Dawson, 346 B.R. 503, 507 (Bankr. N.D. Cal. 2006) (noting that the court issued (continued)

Leeds is particularly instructive. In Leeds, the debtor requested that the court resolve common legal issues applicable to all reclamation claimants before issuing findings of fact concerning each claimant's reclamation rights. In re Leeds Bldg. Prods., Inc., 141 B.R. at 266. This is precisely the relief the Debtors seek here.

14. Therefore, the process proposed by the Debtors is appropriate and any objections thereto should be overruled.

II. THE DEBTORS ARE PERMITTED TO PROCEED BY CLAIM OBJECTION AND ARE NOT REQUIRED TO COMMENCE AN ADVERSARY PROCEEDING.

A. Setoff Is A Defense That May Be Raised In The Context Of A Claim Objection.

15. In the Objections, the Debtors raised setoff as a defense and did not seek to recover affirmatively any property or other amount owed to Circuit City by the Respondents. Nonetheless, certain Respondents argue that the Debtors must commence an adversary proceeding to seek

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a memorandum of decision addressing the underlying legal issues before resolving remaining factual issues); In re Hicks, 300 B.R. 372, 375 (Bankr. D. Idaho 2003) (holding that because a threshold legal issue emerged from the parties' arguments, the court would consider the legal issue first and reserve any evidentiary issues for a subsequent hearing); In re Lenartz, No. 01-40268, 2001 WL 35814401, *1 (Bankr. D. Idaho May 3, 2001) (holding that before conducting an evidentiary hearing on the merits, the court would decide the underlying threshold legal issue).

setoff because setoff amounts to the recovery of money or property under Bankruptcy Rule 7001(1).[7] The Respondents, however, fail to cite any authority to substantiate that contention, and instead, certain Respondents rely on In re Best Products, Co., 203 B.R. 51, 54 (Bankr. E.D. Va. 1996), a case addressing a request for an injunction. See, e.g., Response of Averatec, at p. 10. The Debtors have not, however, requested injunctive relief and any reliance on Best Products is misplaced.

16. More importantly, that contention is inconsistent with Bankruptcy Rule 3007 ands reads Bankruptcy Rule 7001 too broadly. In particular, pursuant to Bankruptcy Rule 3007, the Debtors are permitted to object to claims. See Fed. R. Bankr. P. 3007(a) ("An objection to the allowance of a claim shall be in writing and filed."). Critically, Bankruptcy Rule 3007, not 7001, governs objections to claims. See Fed. Bankr. R. 7001 advisory committee's note (stating that "objections to claims are governed by [Bankruptcy] Rule 3007."). And, critically, by the Objections, the Debtors are not seeking

[7] See Response of Averatec (D.I. 5415), at p. 9; Response of Vonwin Capital Management, L.P. (D.I. 5509), at p. 3, incorporating the Response of Averatec (D.I. 5415).

any affirmative relief such as the recovery of money or property or an injunction, that might otherwise require them to commence an adversary proceeding. See Fed. R. Bankr. P. 3007(b). Instead, the Debtors are only raising an affirmative defense to the allowance of the Administrative Expenses.

17. Specifically, a debtor is authorized (and in certain instances compelled) to raise defenses to claims in a claim objection. See In re Handy Andy Home Imp. Centers, Inc., 222 B.R. 571, 573-74 (Bankr. N.D. Ill. 1998) ("However, just as 'proofs of claim have been held analogous to complaints initiating civil actions[,] an objection to a claim should meet the standards of an answer.' . . . According to Federal Rule of Civil Procedure 8(b), an answering party must 'state in short and plain terms the party's defenses to each claim and shall admit or deny the averments upon which the adverse party relies.'" (internal citations omitted)). Moreover, setoff is a defense. E.g., Apache Prods. v. Mr. Winter, Inc. (In re Apache Prods.), 2004 Bankr. LEXIS 1500, *5 (Bankr. M.D. Fla. Oct. 4, 2004); see also In re Blanton, 105 B.R. 321, 333 (Bankr. E.D. Va. 1989) (characterizing setoff as both a

"defense" and an "equitable remedy"). It follows, that setoff may be raised as a defense in a claim objection.

18. Indeed, at least one court has requested that a debtor assert its setoff rights by way of a claim objection. In re Cumberland Farms, Inc., 249 B.R. 341, 348 (Bankr. D. Mass. 2000) (ordering the debtor to file an objection to a creditor's claim and raise any setoff defenses). Although the Court did not specifically address the issue presented here, in considering the debtor's setoff rights in the context of a claim objection, the Court drew a distinction between circumstances in which a debtor raises setoff as a defense up to the amount of the claim and circumstances in which a debtor seeks to recover amounts in excess of the creditor's claim. See Cumberland Farms, Inc., 249 B.R. at 343-44 ("[The Debtor] asserts setoff rights only. It does not seek judgment against [the creditor] for the excess of its claim over the undisputed portion of the [the creditor's] claim."). After concluding that the debtor was entitled to more than the amount of the creditor's claim, the Court disallowed the claim in full. Because the debtor was not seeking to recover amounts in excess of the claim, the court did not grant any

affirmative relief, such as turnover of additional amounts. Id. at 360.

19. The relief sought by the debtor in Cumberland Farms is precisely the relief requested by the Debtors here. In particular, the Debtors do not seek affirmative relief; they only seek to setoff the Receivables to the extent of the alleged Administrative Expenses.

20. Finally, the procedure employed by the Debtors here is not uncommon. See Brown & Cole Stores, LLC v. Assoc. Grocers, Inc. (In re Brown & Cole Stores, LLC), 375 B.R. 873, 876 (9th Cir. B.A.P. 2007) (noting debtor's objection to an administrative expense claim included a claim for setoff); In re PSA, Inc., 277 B.R. 51, 52-3 (Bankr. D. Del. 2002) (noting that, procedurally, the matter was before the court based on creditor's motion to compel payment under section 503(b)(1)(A) and the debtor's objection to that motion seeking to offset the claim against prepetition receivables).

21. Accordingly, the Debtors were not required to commence an adversary proceeding to raise their setoff rights.

B. The Debtors Are Not Seeking A Declaratory Judgment.

22. Alternatively, certain Respondents argue that the Debtors are seeking a declaratory judgment with regard to the recovery of money or property. As such, they contend that Bankruptcy Rules 7001(1) and (9) govern the Debtors' request.[8] These Respondents, however, read Bankruptcy Rule 7001(9) too broadly, as any claim for partial summary judgment relief would then be considered a declaratory judgment action. It is not.

23. In any event, the Debtors are not seeking to recover money or property; they are asserting an affirmative defense and seeking a legal ruling that Bankruptcy Code section 558 permits the Debtors to setoff the Receivables against the Administrative Expenses. Consequently, Bankruptcy Rule 7001(9) is inapplicable. Accordingly, the Respondents' objections should be overruled.

[8] See Response of Averatec (D.I. 5415), at p. 9; Response of Vonwin Capital Management, L.P. (D.I. 5509), at p. 3, incorporating the Response of Averatec (D.I. 5415); see also Response of Nyko Technologies, Inc. (D.I. 5494), at p. 5; Response of Southpeak Interactive, LLC (D.I. 5501), at p. 5.

III. THE DEBTORS SHOULD BE PERMITTED TO SETOFF THE RECEIVABLES AGAINST THE ADMINISTRATIVE EXPENSES.

A. The Debtors Proposed Setoff Is Consistent With Applicable Law And The Bankruptcy Code's Goals And Objectives.

24. Pursuant to Bankruptcy Code section 558, the Debtors seek to setoff the Receivables against the Respondents' Administrative Expenses, i.e., 503(b) Administrative Expenses and 503(b)(9) Claims.[9] In response, collectively the Respondents assert that (i) the Debtors are not permitted to setoff against their Administrative Expenses,[10] (ii) if Debtors are so permitted, they must

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[9] As set forth in the Objection, section 558 preserves the Debtors' state law setoff rights. In the Objection the Debtors cited Virginia setoff law for illustrative purposes. Certain Respondents, however, objected to the Debtors use of Virginia setoff law. Setting aside the issue of which state law applies for a subsequent hearing, the Respondents ignore the fact that the setoff standard is nearly identical under various state laws that could apply. See, e.g., Heimbrock v. Heimbrock, No. CV085004975S, 2009 WL 1662469, *3 (Conn. Super. Ct. 2009) (stating that the law of set-off requires that there be mutual debts between the parties); Clark v. Cannon Steel Erection Co., 835 N.E. 2d 394, 402 (Ill. App. Ct. 2005) (same); Schwalm v. Zachrais Constr., No. 00-06-090, 2002 WL 596808, *8 (Feb. 7, 2002) (same); Granberry v. Islay Invs., 889 P.2d 970, 972-73 (Cal. 1995) (same); In re Midland Ins. Co., 79 N.Y. 2d 253, 259 (N.Y. 1992) (same); Billman v. State of Md. Deposit Ins. Fund Corp., 593 A.2d 684, 691 (Md. 1991) (same); Cooper v. Hubbard, 703 S.W. 2d 494, 496 (Ky. App. 1986) (same); Fed. Deposit Ins. Corp. v. Pioneer State Bank, 382 A.2d 958, 962 (N.J. 1977) (same); Sarkeys v. Marlow, 235 P.2d 676, 677 (Okla. 1951) (same); In re Kenin's Estate, 29 A.2d 495, 496 (Pa. 1943) (same); Everglade Cypress Co. v. Tunnicliffe, 107 Fla. 675, 678 (1933) (same); Brown v. Perry, 156 A. 910, 914 (Vt. 1931) (same); Woods v. Metro. Nat'l Bank, 234 P. 672, 672 (Wash. 1925) (same).

[10] See Response of Averatec, at p. 11; Response of Alliance, at p. 14; Response of Imagination Entertainment (D.I. 5533); Response of

(continued)

setoff first against the Respondents' unsecured claims, and then, to the extent any Receivables remain, against the Administrative Expenses,[11] or (iii) in the event the Debtors are permitted to setoff the Receivables against the Administrative Expenses, pre-petition Receivables should only be setoff against unsecured claims and post-petition Receivables should be setoff against the Administrative Expenses, including the 503(b)(9) Claims.[12] The Debtors, however, contend that setoff (1) furthers the goals and objectives of the Bankruptcy Code, and (2) is consistent with Fourth Circuit law concerning administrative expenses.

25. First, the Debtors should be authorized to setoff the Receivables against the Administrative Expenses because such relief is consistent with the Bankruptcy Code's goals and objectives. E.g., Official Comm. of Unsecured Creditors v. Mfrs. & Traders Trust Co. (In re The

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Thomson, Inc. (D.I. 5518), at p. 3; Response of Vonwin Capital Management, L.P. (D.I. 5509), at p. 3, incorporating the Response of Averatec (D.I. 5415); see also Response of Digital Innovations, LLC on behalf of Vonwin Capital Management, L.P. (D.I. 5474), at p. 3; Response of Nyko Technologies, Inc. (D.I. 5494), at p. 2; Response of Southpeak Interactive, LLC (D.I. 5501), at p. 2.

[11] See Response of Actiontec (D.I. 5382); Response of Alliance, at p. 17; Response of TiVo Inc. (D.I. 5426), at p. 2; see also Response of Audiovox Corporation (D.I. 5476), at p. 3; Response of SIMA Products Corp. (D.I. 5485) at p. 3.

[12] See Response of TiVo Inc. (D.I. 5426), at p. 4.

Bennett Funding Group, Inc.), 212 B.R. 206, 212 (2d Cir. B.A.P. 1997), aff'd 146 F.3d 136 (2d Cir. 1998) ("Once the technical requirements of setoff are satisfied, 'the bankruptcy judge must scrutinize the right of setoff in light of the Bankruptcy Code's goals and objectives."). "Specifically, [t]hese goals [and objectives] include . . . equitable treatment of all creditors.'" Id. (emphasis added); Matter of Martin, 130 B.R. 930, 939 (Bankr. N.D. Ill. 1991) ("In analyzing the doctrine of setoff, courts have scrutinized its application in light of the goals and objectives of bankruptcy. Few will dispute that . . . equitable treatment of creditors is a goal Congress intended to achieve through an orderly bankruptcy process." (internal citations omitted)). Consequently, the Court evaluating setoff should favor the treatment that is most likely to result in equal distributions to the Debtors' creditors as a whole. See In re Colonial Realty Co., 229 B.R. 567, 575 (Bankr. D. Conn. 1999) (holding that the right to setoff is not absolute and must be balanced against the debtor's duty to maximize assets of the bankruptcy estate and equitable treatment of other creditors).

26. Here, allowing the Debtors to offset the Receivables against the Administrative Expenses will result in the greatest recovery to creditors because it will permit the Debtors to reduce the highest priority claims asserted against their estates on a dollar-for-dollar basis and thereby increase the assets available to similarly situated and junior creditors.

27. Critically, in the absence of a statute directing otherwise, this court retains the discretion to allocate the Debtors' offset rights in this fashion. See United States Internal Revenue Serv. v. Martinez (In re Martinez), 2007 U.S. Dist. LEXIS 6163 (M.D. Pa. Jan. 29, 2007) (holding that the bankruptcy court had discretion to restrict setoff solely to priority claims where creditor also held a general unsecured claim against the debtor). As one court recognized, "the right of setoff is within the bankruptcy court's discretion, and it may 'invoke equity to bend the rules,' if required, to avert injustice." In re The Bennett Funding Group, Inc., 212 B.R. at 212.

28. This is especially true here because the Respondents have asserted 503(b)(9) Claims, which, until recently, were general unsecured claims, except to the extent the Respondent had a valid setoff right. See In re

Laues, 90 B.R. 158, 162 (Bankr. E.D.N.C. 1988) (stating that "[a] claim that is subject to setoff is treated as a secured claim to the extent of the amount subject to setoff, but it is treated as secured *only to that extent*.") As secured claims, such claims received payment in full up to the amount of the setoff. See In re Thompson, 182 B.R. 140, 154 (Bankr. E.D. Va. 1995) ("[A]s a general proposition, a '[s]etoff ... elevates an unsecured claim to secured status, to the extent that the debtor has a mutual, pre-petition claim against the creditor.'") (quoting Lee v. Schweiker, 739 F.2d 870, 875 (3d Cir. 1984). Consequently, until 2005, it was irrelevant which aspect of the Claimants' pre-petition claims was subject to setoff.

29. By adding Bankruptcy Code section 503(b)(9) as part of the 2005 amendments, Congress altered the treatment for certain pre-petition claims such that the claims would be paid in full under a plan, regardless of whether the claimant asserted a setoff right. See In re Brown & Cole Stores, LLC, 375 B.R. at 879 (reasoning that 503(b)(9) claims by definition are pre-petition claims); see also 11 U.S.C. § 1129(a)(9) (providing for payment in full of claims specified in section 507(a)(2)).

30. Under the current law, if the Debtors are prohibited from offsetting the Receivables against the 503(b)(9) Claims, the Respondents will receive payment in full on account of pre-petition claims converted to priority under Bankruptcy Code section 503(b)(9) and payment in full on the portion of their unsecured claim equal to the amount of the Receivables. Consequently, each Respondent will receive payment in full equal to twice the amount entitled to payment in full prior to the 2005 Bankruptcy Code amendments.

31. As a result, the Debtors' other creditors will be deprived of the benefit of having administrative priority claims reduced on a dollar-for-dollar basis, which will necessarily result in fewer assets available to distribute to the greater creditor group.

32. Thus, to further the goals and objectives of the Bankruptcy Code, this Court should authorize the Debtors to setoff the Receivables against the Administrative Expenses, with the Debtors' rights with respect to any remaining Receivables preserved.

33. Second, the Debtors' proposed setoff is consistent with the Fourth Circuit's general mandate to construe administrative expenses narrowly to preserve the

Debtors' resources for equal distributions. As this Court is well aware, the Fourth Circuit Court of Appeals has repeatedly held that administrative expenses must be narrowly construed. E.g., Ford Motor Credit Co. v. Dobbins, 35 F.3d 860, 865 (4th Cir. 1994) (holding that "statutory priorities must be narrowly construed."); In re Merry-Go-Round Enterpr. v. Simon DeBartolo Group, 180 F.3d 149, 157 (4th Cir. 1999) (same). This is true because "[t]he presumption in bankruptcy cases is that the debtor's limited resources [should] be equally distributed among the creditors." Id. Here, the proposed setoff best preserves the Debtors' limited resources because it enables the Debtors to realize value on the Receivables against the highest priority claims asserted against their estates and retain other assets for other pari passu and junior creditors.

B. Bankruptcy Code Section 553 Does Not Bar The Debtors' Proposed Setoff.

34. Notwithstanding the foregoing, certain Respondents also contend that the Debtors' proposed setoff is barred under Bankruptcy Code section 553 because it impairs any potential setoff rights the Respondents may

have thereunder.[13] In support, the Respondents rely upon the phrase "[e]xcept as otherwise provided in this section . . . this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title." See 11 U.S.C. § 553. In reaching this conclusion, however, the Respondents misconstrue section 553's application.

35. The phrase relied upon by the Respondents has been specifically and repeatedly held not to create any independent rights. See In re Calore Exp. Co., Inc., 288 F.3d 22, 43 (1st Cir. 2002) ("As a general matter, 11 U.S.C. § 553 does not create a scheme of priority for the setoff rights it preserves, any more than it creates those rights themselves."); In re Bennett Funding Group, Inc., 146 F.3d 136, 138-39 (2d Cir. 1998) ("Section 553(a) . . . does not create a right of setoff, but rather preserves whatever right exists under applicable non-bankruptcy law."). Instead, the phrase has been interpreted to merely preserve a creditor's setoff right, if any, under applicable state law. Id.; see also In re Camellia Food Stores, Inc., 287

[13] See Response of Alliance, at p. 20; Response of TiVo Inc., at p. 3.

B.R. 52, 59 (Bankr. E.D. Va. 2002 ("No federal right of setoff is created by the Bankruptcy Code[.] [Section 553] merely preserves the right of setoff as it is allowed under nonbankruptcy law with certain limitations.").

36. More importantly, there is an additional hurdle to overcome to assert setoff rights under section 553. Specifically, the creditor must establish that both debts arose prior to the petition date. See In re Camellia, 287 B.R. at 59 (noting that in order to claim a right of setoff pursuant to section 553, a creditor must demonstrate "(1) a debt owed by the creditor to the debtor, which arose prior to the commencement of the bankruptcy case; (2) a claim of the creditor against the debtor, which arose prior to the commencement of the bankruptcy case").

37. Assuming, arguendo, the Respondents can satisfy a pre-petition right of setoff under state law, this Court must still consider the equities of the case to determine whether setoff is warranted. See In re Securities Group 1980, 74 F.3d 1103, 1114 (11th Cir. 1996) ("[T]he right to a set off under § 553 is merely permissive and subject to the discretion of the bankruptcy court."); In re Lambert Oil Co., Inc., 347 B.R. 508, 520 (W.D. Va. 2006) ("After a court determines that the prerequisites for

setoff exist, it generally looks to the equities to determine if the setoff should be allowed.").

38. Certain Respondents contend that it would be inequitable to permit the Debtors to setoff first against their Administrative Expenses because it would deprive them of any setoff against their unsecured claims. The Respondents argument is more properly characterized as marshalling.

39. Marshalling, however, is simply not applicable. In particular,

> The equitable doctrine of marshaling exists for the benefit of persons who hold a subordinate secured claim in property; it holds that where a secured creditor has a lien on two funds or parcels, and the junior lienor has a lien on only one of those two properties, a court of equity may compel the former to satisfy his debt out of the property which is encumbered by only his lien.

In re Price, 50 B.R. 226, 230 (Bankr. E.D. Mich. 1985); see also Meyer v. United States, 375 U.S. 233, 236 (1963) (stating that "the equitable doctrine of marshalling [sic] rests upon the principle that a creditor having two funds to satisfy his debt may not, by application of them to his demand, defeat another creditor, who may resort to only one of the funds." (quotation omitted)).

40. None of the Respondents is a junior secured lienholder, but rather all of the Respondents are simply alleged administrative creditors and/or unsecured creditors. Consequently, the Respondents' rights to insist on the Debtors proceeding first against their unsecured claims is questionable at best. Compare, Gayley & Lord Inc. v. Arley Corp., 239 B.R. 261, 274 (Bankr. S.D.N.Y. 1999)(noting that "[a]n unsecured creditor has no standing to invoke the doctrine" of marshaling)(quotations omitted), with, In re Williams, 345 B.R. 853, 857 (Bankr. S.D. Ohio 2006)(noting that "doctrine of marshaling of assets is usually invoked by a junior secured creditor", but noting that may be part of a debtors powers under section 541(a)); see also Meyer, 375 U.S. at 237 (purpose of marshaling is to prevent arbitrary action of senior lienor from destroying the rights of a junior lienor or a creditor having less security").

41. Moreover, under the present facts and circumstances, the principles of fair dealing and justice overwhelmingly weigh in favor of the Debtors being authorized to offset their Receivables against the Administrative Expenses.

42. First, the Court cannot lose sight of the fact that the Debtors have fiduciary obligations to their creditors. Thus, this Court, "as a forum for resolving large and complex mass litigations, has substantial power to reorder creditor-debtor relations[.]" See In re Dow Corning Corp., 280 F.3d 648, 656 (6th Cir. 2002). Here, the Debtors are simply attempting to do that by offsetting the Receivables against the Administrative Expenses. Critically, in so doing, the Debtors are simply exercising their equitable rights for the benefit of its administrative and priority creditors to ensure that there are sufficient funds to effect confirmation of its plan of reorganization and payment in full to its administrative and priority creditors in accordance with section 1129(a)(9). The Respondents can make no similar argument.

43. Second, the equities favor the Debtors' proposed setoff because the Respondents are receiving the full benefit of their bargain. Specifically, under the Debtors' proposal, the Respondents will receive the equivalent of payment in full on account of the Administrative Expenses. See In re PSA, Inc., 277 B.R. at 54 ("[T]he use of setoff rights does not operate as a denial of [the creditor's claim]. . . . [the creditor will

not] be harmed if the Debtors' postpetition debt and prepetition receivables are setoff. [The creditor] will receive the equivalent of payment because its own debt will be extinguished."). Satisfaction of the Respondents' claims by extinguishing debts owed to Circuit City does not erode the value of those claims as alleged by the Respondents.[14]

44. Finally, as discussed more fully herein, allowing the Debtors to offset the Receivables against the Administrative Expenses will result in the greatest recovery to the entire creditor body. In particular, the proposed setoff will permit the Debtors to reduce the highest priority claims asserted against their estates, thereby increasing the assets available to similarly situated and junior creditors.

45. Accordingly, the equities of this case favor allowing the Debtors to setoff the Receivables against the Administrative Expenses without regard to any potential setoff rights of the Respondents under section 553.[15]

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[14] See Response of Alliance, at p. 16.

[15] Certain Respondents, who purchased their claims from the original claimants ("the "Assignee Respondents"), argue that the Debtors may not assert the equitable defense of setoff. In support, the Assignee Respondents contend that the Debtors lack mutuality and setoff may only be asserted against original claimants and not

(continued)

C. Assuming, Arguendo, Section 553 Bars Setoff Against Post-Petition Administrative Expenses, Section 553 Would Not Bar Setoff Against 503(b)(9) Claims Because They Are Pre-Petition Claims.

46. Although claims asserted under section 503(b)(9) are entitled to administrative priority, such claims are "pre-petition" claims. See In re Brown & Cole, 375 B.R. at 879 (reasoning that 503(b)(9) claims by definition are pre-petition claims). As pre-petition claims, the 503(b)(9) Claims are no different than the Respondents' unsecured claims for purposes of (i) any protection afforded by section 553, and (ii) the Debtors' setoff rights under section 558. Thus, section 553 does not bar (as discussed above and in the Objection, section

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assignees to claims. See Response of United States Debt Recovery (D.I. 5536). The Assignee Respondents are incorrect.

Under state law, assignees take claims subject to the same defenses as the assignor. See Libby, McNeil, and Libby v. City Nat'l Bank, 592 F.2d 504, 513 (9th Cir. 1978) (finding that the assignee "must stand in the shoes" of the assignor for set-off purposes); Concrete Structures, Inc. v. Oxford Dev. Corp., 23 B.R. 605, 614 (E.D. Va. 1982) (applying Maryland law to find that an assignee's rights in receivables was subject to any defense or claim that could have been brought against the assignor); see also Iowa Oil Co. v. Citgo Petroleum Corp. (In re Iowa Oil Co.), No. C04-1002-LRR, 2004 WL 2326377, *6 (N.D. Iowa Sep. 30, 2004) (noting that the legislature codified the familiar common law concept that "claims of an assignee are no higher or greater than those of the assignor"); Schneider Nat'l, Inc. v. Bridgestone/Firestone, Inc., 200 F. Supp. 2d 1006, 1011 (E.D. Wis. 2001) (noting that in an analogous situation, state law provided that the "rights of an assignee are subject to . . . any claim or defense" that could have been brought against the assignor).

Thus, the Debtors may assert any defenses against the Assignee Respondents that they could have asserted against the original claimholders.

558 authorizes) setoff of the Receivables against the 503(b)(9) Claims.

IV. THE DOCTRINE OF RECOUPMENT IS INAPPLICABLE.

47. Certain Respondents argue that the Debtors may not setoff the Receivables pursuant to 11 U.S.C. § 558 because to do so would impair their alleged right to recoup.[16] The Debtors, however, contend that the doctrine of recoupment is inapplicable because the equities favor granting the Debtors' setoff under section 558 and the Respondents cannot satisfy the applicable standard.

48. Recoupment is an equitable defense similar to setoff. Tavenner v. United States (In re Vance), 298 B.R. 262, 267 (Bankr. E.D. Va. 2003) ("Recoupment is an equitable doctrine that has long been applied in the bankruptcy context."); In re Camellia, 287 B.R. at 60 (noting that recoupment is an equitable doctrine). As an equitable defense, application of recoupment is within this Court's discretion and should only be permitted if the equities warrant the relief. In re Straightline Investments, Inc., 525 F.3d 870, 882 (9th Cir. 2008) (noting that the court has discretion whether to allow a defense of

[16] See Response of Alliance, p. 10.

recoupment); In re Vance, 298 B.R. at 269 ("When applying the doctrine of recoupment, courts must be "'guided by basic principles of equity.'") (quoting Tidewater Mem'l Hosp., Inc. v. Bowen (In re Tidewater Mem'l Hosp., Inc.), 106 B.R. 876, 882 (Bankr. E.D. Va. 1989)). For the reasons discussed in section III of this Reply, the Debtors submit that the equities favor granting the Debtors' setoff under section 558 and denying any alleged recoupment rights.

49. To the extent the doctrine of recoupment might be available to the Respondents, this Court should set forth the applicable legal standard and provide the Debtors and the Respondents guidance with respect to its application. The Debtors submit that this Court should follow decisions from this District and throughout the Fourth Circuit, which have adopted the integrated transaction test and rejected the logical relationship test.

50. In adopting the integrated transaction test, courts in this District and throughout the Fourth Circuit have characterized recoupment as "the right of the defendant to have the plaintiff's monetary claim reduced by reason of some claim the defendant has against the plaintiff arising out of the very contract giving rise to

the plaintiff's claim." In re Vance, 298 B.R. at 267 (internal citations omitted). Moreover, this definition has been interpreted narrowly. See In re Ravenwood Healthcare, Inc., 2006 WL 4481985, *2 (Bankr. D. Md. 2006) ("'Recoupment is 'narrowly construed' in bankruptcy cases . . . '") (internal citations omitted); In re Fas Mart Convenience Stores, Inc. 296 B.R. 414, 422 (Bankr. E.D. Va. 2002) ("Generally, courts have narrowly construed the doctrine of recoupment.").

51. Indeed, for recoupment to apply, the basis for the recoupment demand must arise from the "same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim." E.g., In re Thompson, 182 B.R. at 174 (Bankr. E.D. Va. 1995); University Med. Ctr. v. Sullivan (In re University Med. Ctr.), 973 F.2d 1065, 1081 (3d Cir. 1992). In evaluating the meaning of "same transaction", courts in this District and in this Circuit apply the "integrated transaction test." See In re Vance, 298 B.R. at 267; see also Georgetown Steel Co., LLC v. Capital City Ins. Co. (In re Georgetown Steel Co., LLC), 318 B.R. 313, 331 (Bankr. D.S.C. 2004) ("Therefore, the Fourth Circuit and cases within the Circuit are closely aligned with the 'integrated

transaction' test"); In re Colonial Health Investors, LLC, 2001 WL 34388127, *4 (Bankr. W.D.N.C. 2001) (adopting the integrated transaction test). This test requires that "both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations." Id. at 268 (citing University Med. Ctr., 973 F.2d at 1081)) (emphasis added).

52. For example, in the University Med. Ctr. case, the court denied recoupment, because even though the parties had an ongoing business relationship, that relationship was not sufficient to support the conclusion that Medicare overpayments made to the debtor in one year could be recouped by subsequent Medicare reimbursements due the debtor in another year. The court reasoned that reimbursements for health care services provided by the debtor in later years were separate and distinct transactions from the services provided that gave rise to the earlier overpayments. As the court stated, "[t]o conclude that these claims arose from the same transaction for the purposes of equitable recoupment would be to contort that doctrine beyond any justification for its creation." University Med. Ctr., 973 F.2d at 1082.

53. In this case, the Respondents contend that the Receivables may be recouped against each Respondent's general unsecured claim as opposed to the Administrative Expenses. As the parties seeking recoupment, the Respondents have the burden of proving all of the elements of the recoupment defense. See In re Koch, 224 B.R. 572, 575 (Bankr. E.D. Va. 1998) (explaining that the defendant carries the burden of proof when it asserts the defense of recoupment).

54. The Debtors contend that the Respondents will not be able to satisfy their burdens of demonstrating that the Receivables and the general unsecured claims (1) arose from the same underlying contractual agreement and, (2) arose as part of a single integrated transaction. In any event, as a determination of this issue depends on individual facts specific to each Respondent, it should be considered at a subsequent hearing.

V. FACTUAL DISPUTE SHOULD BE RESERVED FOR A HEARING AFTER THE COURT RESOLVES THE THRESHOLD LEGAL ISSUES AND DISCOVERY CONCLUDES.

55. The Respondents raised various issues of fact in their Responses. The Debtors disagree with such factual issues, but do not intend to address such issues at the Hearing. Instead, as set forth in the Objection and

this Reply, subject to the Court's approval, the Debtors have requested resolution of legal issues only. Indeed, the Debtors will not request entry of an order authorizing setoff with respect to any of the Respondents at the Hearing. Only after discovery, if any, and a subsequent hearing on the merits will the Debtors seek entry of orders resolving the Objection with respect to the Respondents.

CONCLUSION

WHEREFORE, the Debtors request the Court to enter the Order sustaining the Objection and granting such other and further relief as the Court deems appropriate.

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SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP
Gregg M. Galardi, Esq.
Ian S. Fredericks, Esq.
P.O. Box 636
Wilmington, Delaware 19899-0636 (302) 651-3000

- and -

SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP
Chris L. Dickerson, Esq.
155 North Wacker Drive
Chicago, Illinois 60606
(312) 407-0700

- and -

MCGUIREWOODS LLP

/s/ Douglas M. Foley
Dion W. Hayes (VSB No. 34304)
Douglas M. Foley (VSB No. 34364)
One James Center
901 E. Cary Street
Richmond, Virginia 23219
(804) 775-1000

Counsel for Debtors and Debtors in Possession